Economic Outlook

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Despite the volatility in financial markets, the real economy continues to show substantial strength. Adding to the outlook for further expansion is the improving composition of growth. Over the past year, growth in exports and business investment has picked up sharply, while consumption and Federal government spending have grown at about half the overall GNP rate. The real economy is contributing significantly to the long-awaited improvement in the twin deficits--budget and trade.

Real Growth

3Q 1986 - 3Q 1987
percent change

Consumption	1.6
Federal Government Spending	1.7
State & Local Government Spending	3.0
Total GNP	3.0
Private Domestic Investment	4.9
Net Exports	14.7

The October labor market statistics show the economy off to a very strong start in the fourth quarter. The manufacturing sector, where export business is strong, is likely to move into a full-fledged boom over the next few months. Factory overtime has reached levels last seen in the mid-1970s and the recent further depreciation of the dollar is likely to add even more stimulus. This heightens the prospects for increased inflation down the road. Industry has less slack capacity than it had during the first wave of dollar depreciation.

The main uncertainty in the outlook is the impact of the recent stock market decline on economic activity, especially consumption. Stock market declines can hurt the economy in two basic ways. They can cause a general confidence crisis leading most consumers and businesses to be extremely cautious in their spending and production plans. This is only likely to happen if there is a general liquidity crisis, like in the 1930s. The Federal Reserve's aggressive action has averted such a crisis for now. A second channel of stock market influence is what economists call the "wealth effect." Households, feeling poorer when share values decline, reduce consumption and increase saving, thus slowing down the economy.

The wealth effect from the recent stock market decline is likely to be quite small for a couple of reasons. First, the wealth lost was very short-lived; households still have almost as much stock market wealth as they did late last year. What they have lost are this year's gains, which are unlikely to have been fully incorporated into future spending plans. Second, the wealth effect is highly concentrated in upper income groups (See table). As income increases, households are more likely to own stock, own larger amounts, and hold stocks as a larger share of their overall portfolio. Almost 90% of households own little if any stock directly ($5,000 or less).

Distribution of Share Ownership

Income (percentile)	Own Stock (percent)	Share of Portfolio (percent)
0-90	15	N.A.
90-98	47	10
98-99	61	17
99-99.5	75	19
99.5-100	90	20

Thus the real damage is focused in the top income decile. These people will cut back on some upscale consumption items, settling for a Cadillac instead of a Jaguar, or an Aspen ski vacation instead of the Alps, but the effect on the economy will be small. Also, as the example suggests, luxury imports are likely to decline disproportionately, helping to shrink the trade deficit. First indications from car sales data support this expectation, as the sharpest declines were in European luxury imports. Post-October 19 consumer surveys show some decline in consumer confidence, but nothing compared with earlier crises, like the gasoline lines and credit controls. Unless a general confidence crisis develops, a recession is extremely unlikely.

Robert T. McGee

Real GNP

(Percent Contribution to Real GNP Growth; Annual Rates)	Actual 1986 IV	Actual 1987 I	Actual 1987 II	Actual 1987 III	Forecast 1987 IV	Forecast 1988 I	Forecast 1988 II	Forecast 1988 III	Actual 1985-1986	Forecast 1986-1987	Forecast 1987-1988
Consumer Spending	0.3	-0.5	1.2	3.2	0.0	1.0	1.0	1.0	2.7	1.3	1.1
Business Investment	0.6	-1.9	1.3	2.5	0.6	0.6	0.6	0.6	-0.3	0.1	0.9
Residential Investment	0.1	-0.4	-0.2	0.0	0.0	-0.1	-0.1	-0.1	0.6	-0.0	-0.1
Change in Inventories*	-0.1	4.4	-1.6	-1.7	-0.1	0.8	0.5	0.2	0.0	0.1	-0.3
Net Exports	1.1	1.8	0.3	-0.6	2.0	0.8	0.9	0.5	-1.0	0.4	0.8
Government Purchases*	-0.5	1.0	1.5	0.4	0.5	0.5	0.6	0.5	0.9	0.8	0.8
Real GNP	1.5	4.4	2.5	3.8	3.0	3.6	3.4	2.7	2.9	2.7	3.2

Quarterly Economic Indicators

(Percent Changes at Annual Rates)	Actual 1986 IV	Actual 1987 I	Actual 1987 II	Actual 1987 III	Forecast 1987 IV	Forecast 1988 I	Forecast 1988 II	Forecast 1988 III	Actual 1985-1986	Forecast 1986-1987	Forecast 1987-1988
Nominal GNP	2.1	8.6	6.3	6.2	7.2	8.7	9.1	8.5	5.6	5.8	8.0
GNP Deflator	0.7	4.2	3.5	2.4	4.0	4.9	5.4	5.8	2.6	3.0	4.6
Corporate Profits After Tax#	-0.3	6.7	9.9	6.3	6.3	12.5	10.1	8.5	-1.0	7.3	9.5

Monthly Economic Indicators

	Recent Data Aug.	Recent Data Sept.	Recent Data Oct.	Actual 1986	Forecast 1987	Forecast 1988
Consumer Price Index** (%)	0.5	0.2	n.a.	1.1	5.2	6.1
Industrial Production (%)	0.3	0.2	n.a.	1.0	3.6	4.3
Retail Sales (%)	1.3	-0.4	n.a.	5.5	3.8	4.1
Auto Sales (million units, a.r.)	12.4	11.8	9.2	11.5	10.3	10.0
Housing Starts (million units, a.r.)	1.60	1.67	n.a.	1.81	1.65	1.58
Unemployment Rate (%)	6.0	5.9	6.0	7.0	6.2	5.6
Merchandise Trade Deficit ($ bn., a.r.)	-187.2	-169.0	n.a.	-156.2	-165.0	-135.0

*Adjusted for CCC purchases. **Annual percent changes are December to December.
#Quarterly data are year-over-year percent changes.
a.r.=annual rate F=Forecast